INDEX

	Page
Opinions below	1
Jurisdiction	2
Question presented	2
Statute and regulations involved	2
Statement	3
Reasons for granting the writ	6
Conclusion	11
Appendix	12

CITATIONS

Case:	
Commissioner v. *Shoong*, C. A. 9, decided September 9, 1948	6, 9
Statute:	
Internal Revenue Code:	
Sec. 23 (26 U.S.C. 1946 ed., Sec. 23)	6, 7, 8, 12
Sec. 125 (26 U.S.C. 1946 ed., Sec. 125)	6, 8, 12
Miscellaneous:	
1945 C.C.H., par. 6139	8
1945 P-H, par. 76,157	8
Treasury Regulations 111:	
Sec. 29.125-1	16
Sec. 29.125-2	17
Sec. 29.125-3	18
Sec. 29.125-4	19
Sec. 29.125-5	20

In the Supreme Court of the United States

OCTOBER TERM, 1949

No. 384

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHRISTIAN W. KORELL

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit, entered June 8, 1949, rehearing denied, July 14, 1949, affirming the judgment of the Tax Court of the United States.

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 9-14) are reported at 10 T. C. 1001. The initial opinion of the Court of Appeals (R. 17-21) and the opinion on rehearing (R. 31-2) have not yet been reported.

JURISDICTION

The judgment of the Court of Appeals was entered June 8, 1949. (R. 21.) A petition for rehearing was denied July 14, 1949. (R. 32-3.) The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

In August 1944, taxpayer purchased callable debenture bonds, of $100 face value, at slightly over $121; the bonds were then callable by the debtor at $104; they were also immediately convertible (at the holder's option) into the debtor's stock, which was selling at about $163, on surrender of $100 face value plus $40 in cash. On these facts, the Tax Court and the Court of Appeals recognized that the excess over the call price was not paid because of high interest returnable on the bonds but represented consideration paid for the valuable conversion option.

The question presented is whether the taxpayer is nevertheless entitled to an "amortizable bond premium" deduction from gross income for the taxable year 1944, measured by the difference between the cost of the bonds ($121) and the call price ($104).

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the Internal Revenue Code and Treasury Regulations are printed in the Appendix, *infra*, pp. 12-21.

STATEMENT

The facts were stipulated (R. 2-9), and were found by the Tax Court as stipulated (R. 9-10):

The taxpayer, Christian W. Korell, is an individual residing in New York, New York, and having an office at 50 Broadway, New York, New York. During 1944, the taxpayer purchased $50,000 principal amount of American Telephone and Telegraph Company 15-year, three per cent convertible debenture bonds, due September 1, 1956, as follows (R. 9):

Purchase Date	Face Value	Unit Price	Amount Paid
August 16, 1944	$11,000	at 121⅛	$13,351.25
August 16, 1944	2,000	at 121	2,425.00
August 22, 1944	37,000	at 121¼	44,862.50
Totals	$50,000		$60,638.75

The average price of the capital stock of the American Telephone and Telegraph Company on August 16, 1944, was $163.1875 per share, and on August 22, 1944, was $163.6875 per share. (R. 9.)

The above bonds were issued under an indenture between the American Telephone and Telegraph Company and City Bank Farmers Trust Company, Trustee, dated September 1, 1941.[1] Section 3.01 of the indenture (R. 4, 9-10) provided in part that on not less than thirty days' notice

[1] A copy of the indenture dated September 1, 1941, was attached as an exhibit to the stipulation of facts. Only the material provisions thereof are printed in the Record. The full indenture is being filed with the Court.

the bonds might be redeemed by the company in whole or in part on any date on or after September 1, 1942—

> at the following redemption prices (expressed in percentages of the principal amount) together with accrued interest to the date fixed for redemption: to and including August 31, 1944, 107%; thereafter to and including August 31, 1948, 104%; thereafter to and including August 31, 1953, 102%; and thereafter, 100%.

Section 4.01 of the indenture of September 1, 1941 (R. 4-5, 10), provided in part that the holder of any such bond—

> shall have the right, at his option, at any time after January 1, 1942, to and including December 31, 1954 (except that, in case any Debenture Bond or Debenture Bonds shall be called for redemption before such latter date and payment thereof duly provided for, such right shall terminate at the close of business on the date fixed for redemption of such Debenture Bond or Debenture Bonds), to convert * * * the principal of any such Debenture Bond * * * into such number of full-paid and non-assessable shares of Capital Stock of the Company as the principal amount of the Debenture Bond * * * surrendered for conversion is a multiple of $100 * * * at the price of $140 per share * * *

by the surrender of $100 principal amount of debenture bonds and payment to the company of

cash equal in amount to the excess of the conversion price over $100.

The entire issue of these bonds was called for payment under the provisions of the above indenture as of September 1, 1947, at 104, plus interest. (R. 10.)

The above American Telephone and Telegraph Company bonds purchased by the taxpayer were not part of the stock in trade of the taxpayer, or includible in any inventory of the taxpayer at the close of the taxable year; held by him primarily for sale to customers in the ordinary course of his trade or business, but they were purchased by him as an investment. The taxpayer did not, during the calender year 1944, sell any of the above bonds purchased by him, nor did he exercise his privilege of converting them into capital stock of the company. (R. 10.) In fact, the record fails to disclose what disposition was made of the bonds by the taxpayer. These American Telephone and Telegraph debentures were the only premium bonds purchased or owned by the taxpayer in the year 1944. (R. 10.)

In his federal income tax return for 1944, the taxpayer claimed as a deduction from gross income, in computing taxable net income, amortization of premium paid in connection with the above $50,000 face amount of bonds in the amount of $8,638.75, representing the difference between $60,638.75, the cost of the bonds, and $52,000, the call price of the bonds at 104, as set out in the inden-

ture of September 1, 1941.[2] (R. 10.) In determining the deficiency here involved, the Commissioner disallowed this deduction of $8,638.75, claimed by the taxpayer as amortizable bond premiums for the year 1944. (R. 3.)

The Tax Court held that this amount, representing the difference between the cost of the bonds involved and the call price thereof at earliest call date, constituted "bond premium" within the meaning of the applicable statutory provisions, and that it therefore was deductible in computing taxable net income for the year involved. (R. 10-14.) The Court of Appeals for the Second Circuit affirmed the decision of the Tax Court. (R. 17-21, 31-2.)

REASONS FOR GRANTING THE WRIT

1. The decision of the Court of Appeals for the Second Circuit in this case is in direct conflict with the later decision of the Court of Appeals for the Ninth Circuit in *Commissioner* v. *Shoong,* decided September 9, 1949 (1949 P-H, Federal Tax Service, par. 72,593). Both cases involve the construction and application of Sections 23 (v) and 125 of the Internal Revenue Code, as amended (Appendix, *infra*), under substantially identical facts.

Sections 23 (v) and 125 were added as amend-

---

[2] Taxpayer considered the call price of the bonds to be the price at which they could have been called if the debtor had given a call notice on the dates of purchase; under the indenture, this was 104. *Supra,* pp. 2-4. If taxpayer is entitled to the deduction, petitioner does not dispute this method of computation (R. 20).

ments to the Internal Revenue Code, effective for any taxable year beginning after December 31, 1941, by Section 126 of the Revenue Act of 1942, c. 619, 56 Stat. 798. Section 23 (v) merely included among the authorized deductions from gross income the allowance for "amortizable bond premium" provided in Section 125. The latter section, in turn, defined "amortizable bond premium," fixed the amount allowable in any taxable year, prescribed the method of determination of the amount deductible, and made other and detailed provisions with respect to the allowance.

a. In this case, the taxpayer purchased in August 1944, $50,000 face amount of American Telephone and Telegraph Company 15-year, three per cent convertible debenture bonds at a cost of more than $121 per $100 face amount thereof. Under the governing trust indenture, these debentures were convertible at the time of purchase and until December 31, 1954, into capital stock of the Company at the rate of one debenture of $100 face amount plus $40 in cash for each share of stock. At the time of purchase, the capital stock of the Company into which the bonds could be converted was selling on the market for approximately $163 per share.[3] At that date, the debentures were callable, on thirty days' notice, at 104. In his income tax return for 1944, the taxpayer deducted, as "amortizable bond pre-

[3] It is to be noted that the market price of the stock ($163) was substantially equal to the market price of the bonds ($121) plus the sum to be paid in cash on conversion ($40).

mium", within the meaning of the above statutory provisions, the difference between the cost of these debentures and their call price on the earliest call date. The Commissioner disallowed the deduction.

The Tax Court found, in accord with a 1945 ruling of the Commissioner involving the same bond issue, that "in the present case, both the call price and the conversion figures indicate that the premium was paid, not for the investment feature of the bond, but for the rights of conversion." (R. 13.) The 1945 ruling of the Commissioner was based on a determination that this differential of more than $20 between the price and the $100 face amount of the bonds represented the market value of the conversion option rather than a premium paid for the investment value of the security itself.[4]

Despite this recognition that the amount involved did not represent premium paid for the investment value of the securities, the Tax Court held that the amount claimed was deductible as "amortizable bond premium" within the meaning of Sections 23 (v) and 125 of the Code. In its view, Congress intended to place all convertible bonds, with-

[4] The ruling is published in 1945 P-H, par. 76.157, and 1945 C.C.H., par. 6139, and is quoted from at length in footnote 15 of the Tax Court's opinion. (R. 12.) It states, in part, that "for nearly two years, the market price of those bonds has fluctuated almost directly in accordance with the quotations on the common stock into which such bonds are, at any time, convertible. This clearly indicates that substantially all of the so-called premium of $23.00 represents the market value of the conversion option, rather than a premium paid for the investment value of the security itself, considered independently of the conversion option" (R. 12). See fn. 3, *supra*, p. 7.

out exception, within the coverage of the deduction (R. 14). The Court of Appeals for the Second Circuit apparently agreed that the amount involved represented consideration paid for the conversion option contained in the bonds but likewise held that "even though the premium paid on them might well be due more to the privilege of conversion than to other features" the amount in question was deductible as amortizable bond premium. (R. 19.)

b. In *Commissioner* v. *Shoong* (C.A. 9), decided September 9, 1949, *supra,* the taxpayers, Joe Shoong and Rose Shoong, in June, 1944, each purchased $500,000 face amount of the same American Telephone and Telegraph Company 15-year, three per cent debentures, issued under this same trust indenture of September 1, 1941, at a cost in excess of $600,000, and in their income tax returns for 1944 each deducted, as amortizable bond premiums under Sections 23 (v) and 125 of the Internal Revenue Code, the difference between the cost of such bonds and the amount at which they were callable at the earliest call date. In reversing the Commissioner's disallowance of such deductions, the Tax Court, in an unreported Memorandum Findings of Fact and Opinion (dated June 14, 1948) (1948 P-H T. C. Memorandum Decisions, par. 48,095), merely followed its earlier decision in the instant case. The Commissioner's appeal in the *Shoong* case involved the same question as that in-

volved in his appeal in the present case. The Court of Appeals reversed the decision of the Tax Court and sustained the Commissioner's disallowance of the deductions, on the ground that the statute did not authorize a deduction for amounts paid in connection with the purchase of convertible debentures which actually represented consideration for the conversion option in the debentures, rather than a true investment premium. Congress intended the "amortizable bond premium" deduction to be allowed, the court held, only where the premium is in fact paid because the interest return on the bonds is higher than the average for comparable obligations. In its opinion, the Court of Appeals for the Ninth Circuit specifically disagreed with the "contrary conclusion" reached by the Court of Appeals for the Second Circuit in the instant case.[5]

2. The question here involved is also a question of general importance in the administration of the Revenue Acts which has not, but which should be, resolved by this Court. The issuance of debentures or other evidences of indebtedness permitting conversion, at the option of the holder, into stock of the issuing corporation is not unusual in corporate finance. Hence the question presented is one of general and continuing importance.

---

[5] The opinion below notes the *Shoong* case as pending on appeal in the Ninth Circuit (R. 18).

CONCLUSION

For the foregoing reasons, it is submitted that the petition for a writ of certiorari should be granted.

Respectfully submitted,

PHILIP B. PERLMAN,
Solicitor General.

OCTOBER, 1949.

APPENDIX

1. Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * *

(v) [as added by Sec. 126 of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Bond Premium Deduction.*—In the case of a bondholder, the deduction for amortizable bond premium provided in section 125.

* * * * *

(26 U.S.C. 1946 ed., Sec. 23.)

SEC. 125 [as added by Sec. 126 of the Revenue Act of 1942, *supra*]. AMORTIZABLE BOND PREMIUM.

(a) *General Rule.*—In the case of any bond, as defined in subsection (d), the following rules shall apply to the amortizable bond premium (determined under subsection (b)) on the bond for any taxable year beginning after December 31, 1941:

(1) *Interest wholly or partially taxable.*—In the case of a bond (other than a bond the interest on which is excludible from gross income), the amount of the amortizable bond premium for the taxable year shall be allowed as a deduction.

(2) *Interest wholly tax-exempt.*—In the case of any bond the interest on which is ex-

cludible from gross income, no deduction shall be allowed for the amortizable bond premium for the taxable year.

(3) *Adjustment of credit in case of interest partially tax-exempt.*—In the case of any bond the interest on which is allowable as a credit against net income, the credit provided in section 25(a)(1) or (2), or section 26(a), as the case may be, shall be reduced by the amount of the amortizable bond premium for the taxable year.

(For adjustment to basis on account of amortizable bond premium, see section 113 (b)(1)(H).)

(b) *Amortizable Bond Premium.*—

(1) *Amount of bond premium.*—For the purposes of paragraph (2), the amount of bond premium, in the case of the holder of any bond, shall be determined with reference to the amount of the basis (for determining loss on sale or exchange) of such bond, and with reference to the amount payable on maturity or on earlier call date, with adjustments proper to reflect unamortized bond premium with respect to the bond, for the period prior to the date as of which subsection (a) becomes applicable with respect to the taxpayer with respect to such bond.

(2) *Amount amortizable.*—The amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year.

(3) *Method of determination.*—The determinations required under paragraphs (1) and (2) shall be made—

(A) in accordance with the method of amortizing bond premium regularly employed by the holder of the bond, if such method is reasonable;

(B) in all other cases, in accordance with regulations prescribing reasonable methods of amortizing bond premium, prescribed by the Commissioner with the approval of the Secretary.

(c) *Election on Taxable and Partially Taxable Bonds.*—

(1) *Eligibility to elect and bonds with respect to which election permitted.*—This section shall apply with respect to the following classes of taxpayers with respect to the following classes of bonds only if the taxpayer has elected to have this section apply.

(A) *Partially Tax-Exempt.*—In the case of a taxpayer other than a corporation, bonds with respect to the interest on which the credit provided in section 25 (a) (1) or (2) is allowable; and

(B) *Wholly Taxable.*—In the case of any taxpayer, bonds the interest on which is not excludible from gross income but with respect to which the credit provided in section 25 (a) (1) or (2), or section 26 (a), as the case may be, is not allowable.

(2) *Manner and effect of election.*—The election authorized under this subsection shall be made in accordance with such regulations as the Commissioner with the approval of the Secretary shall prescribe. If such election is made with respect to any bond (described in paragraph (1)) of the taxpayer, it shall also apply to all such bonds held by the taxpayer at the beginning of the first taxable year to which the election applies and to all such bonds thereafter acquired by him and shall be binding for all subsequent taxable years with respect to all such bonds of the taxpayer, unless, upon application by the taxpayer, the Commissioner permits him, subject to such conditions as the Commissioner deems necessary, to revoke such election. The election authorized under this subsection in the case of a member of a partnership shall be exercisable with respect to bonds of the partnership only by the partnership. In the case of bonds held by a common trust fund, as defined in section 169, or by a foreign personal holding company, as defined in section 331, the election authorized under this subsection shall be exercisable with respect to such bonds only by the common trust fund or foreign personal holding company.

(d) *Definition of Bond.*—As used in this section, the term "bond" means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by any corporation and bearing interest (including any like obligation

issued by a government or political subdivision thereof), with interest coupons or in registered form, but does not include any such obligation which constitutes stock in trade of the taxpayer or any such obligation of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or any such obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

(26 U.S.C. 1946 ed., Sec. 125.)

2. Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.125-1. *In General.*—(a) *Application.*—Section 125 makes provision for the amortization of bond premium by the owners of the bonds. It is mandatory with respect to—

* * * * *

It is optional, at the election of the taxpayer, with respect to—

(1) fully taxable bonds (the interest on which is subject to normal tax and surtax), whether the owner is a corporation, individual, or other taxpayer; and

(2) partially tax-exempt bonds owned by taxpayers other than corporations.

The term "bond" as used in section 125 means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by any corporation and bearing interest (including any like obligation issued by a govern-

ment or political subdivision thereof), with interest coupons or in registered form, but does not include any such obligation which constitutes stock in trade of the taxpayer or any such obligation of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or any such obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Since bonds owned by dealers in securities are excluded from the foregoing definition, section 125 has no application to such dealers.

(b) *Operation.*—In the case of a fully tax-exempt bond, the amortizable bond premium for the taxable year is simply an adjustment to the basis or adjusted basis of the bonds. Thus, if such premium is $1, the basis or adjusted basis of the bond is reduced by $1. No deduction is allowable on account of such amortizable bond premium. In the case of a fully taxable bond to which section 125 is applicable, the amortizable bond premium is both an adjustment to the basis or adjusted basis of the bond and a deduction.

* * * * *

SEC. 29.125-2. *Bond Premium and Amortizable Bond Premium.*—Bond premium on any bond to which section 125 applies is the excess of the amount of the basis (for determining loss on sale or exchange) of the bond over the amount payable at maturity or, in the case of a callable bond, earlier call date. (For determination of applicable call date see sec-

tion 29.125-5.) If the date as of which such basis of the bond was established precedes the first taxable year with respect to which such section applies to the bond, there shall be made adjustments proper to reflect unamortized bond premium on such bond for the period including the holding period (as determined under section 117(h)) prior to the date as of which section 125 first becomes applicable to the bond in the hands of the taxpayer.

* * * * *

Amortizable bond premium on any bond to which section 125 applies is such part of the bond premium on the bond as is attributable to the taxable year.

SEC. 29.125-3. *Methods of Amortization.*— The determinations of the bond premium and amortizable bond premium on any bond to which section 125 applies shall be made in accordance with:

(a) the method of amortization regularly employed by the taxpayer, if such method is reasonable; or

(b) the method of amortization prescribed by this section.

A method of amortization will be deemed "regularly employed" by a taxpayer if the method was consistently followed in taxable years beginning prior to January 1, 1942, or if for taxable years beginning on or after such date the taxpayer (including a taxpayer who followed a different method in taxable

years beginning prior to January 1, 1942) initiates in the first taxable year for which the deduction is taken a reasonable method of amortization and consistently follows such method thereafter. * * *

The method of amortization prescribed by this section is as follows:

(1) The bond premium on any bond to which section 125 applies shall be determined in accordance with section 29.125-2 and shall be computed as of the end of the taxable year (or as of the date of disposition or redemption of the bond, if it was disposed of or redeemed in the taxable year) but without regard to the amortizable bond premium for the taxable year; and

(2) The amortizable bond premium on such bond for the taxable year shall be an amount which bears the same ratio to the bond premium on the bond as the number of months in the taxable year during which the bond was owned by the taxpayer bears to the number of months from the beginning of the taxable year (or, if the bond was acquired in the taxable year, from the date of acquisition) to the date of maturity or earlier call date. For the purposes of this section a fractional part of a month shall be disregarded unless it amounts to more than half a month in which case it shall be considered as a month.

SEC. 29.125-4. *Election.*—In the case of a corporation, the election provided in section

125 may be made only with respect to fully taxable bonds. In the case of a taxpayer other than a corporation, the election provided in such section may be made with respect to (a) fully taxable bonds only, or (b) partially tax-exempt bonds only, or (c) both fully taxable bonds and partially tax-exempt bonds. Such election shall be made by the taxpayer by claiming a deduction for the bond premium in his return for the first taxable year to which he desires the election to be applicable. No other method of making such election is permitted. If the election is so made, the taxpayer should attach to his return a statement showing the computation of the deduction. The election shall apply to all bonds in respect of which it was made owned by the taxpayer at the beginning of the first taxable year to which the election applies and also to all bonds of such class (or classes) thereafter acquired by him, and shall be binding for all subsequent taxable years. Upon application by the taxpayer, the Commissioner may permit him to revoke the election, subject to such conditions as the Commissioner deems necessary. * * *

SEC. 29.125-5. *Callable and Convertible Bonds.*—The fact that a bond is callable or convertible into stock does not, in itself, prevent the application of section 125. For the purposes of such section, in the case of a callable bond the earlier call date will be considered as the maturity date and the amount due on such date will be considered as the amount payable on maturity, unless the tax-

payer regularly employs a different method of amortization which is reasonable. Hence, the bond premium on such a bond is required to be spread over the period from the date as of which the basis for loss of the bond is established down to the earlier call date, rather than the maturity date. The earlier call date may be the earliest call date specified in the bond as a day certain, the earliest interest payment date if the bond is callable at such date, the earliest date at which the bond is callable at par, or such other call date, prior to maturity, specified in the bond as may be selected by the taxpayer. A taxpayer who deducts amortizable bond premium with reference to a particular call date may not thereafter use a different call date in the calculation of amortization deductions with respect to such premium. A convertible bond is within the scope of section 125 if the option to convert on a date certain specified in the bond rests with the holder thereof.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1949 — 883071 — 214